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ABSTRACT

This General Accounting Office (GAO) testimony before the Subcommittee on Postsecondary Education, Committee on Education and Labor, House of Representatives, concerns the findings of the task force that addressed the increasing costs of student loan defaults. The task force report is considered, generally, to provide additional incentives and tools for program participants to use to better manage their programs and control defaults and to complement recent legislative and regulatory changes. The following topics are discussed: (1) characteristics of defaulters; (2) task force proposals; (3) lender risk sharing; and (4) origination fees for other loan programs. The task force proposal to substantially increase Pell Grant funding is not considered advisable, due to its cost in comparison to the much smaller default savings it would realize. Two proposals are offered that were not proposed in the task force report: (1) lender risk sharing (providing a stronger incentive to avoid defaults and improve their collections efforts); and (2) charging loan origination fees for loans guaranteed under the Parent Loans for Undergraduate Students (PLUS) and the Supplemental Loans for Students (SLS) programs. (KM)

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GAO's Views on the Default Task Force's Recommendations for Reducing Default Costs in the Guaranteed Student Loan Program

Statement of
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Before the
Subcommittee on Postsecondary Education
Committee on Education and Labor
House of Representatives

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HE 021 309

SUMMARY OF GAO TESTIMONY BY WILLIAM J. GAINER ON
THE DEFAULT TASK FORCE RECOMMENDATIONS FOR REDUCING
DEFAULT COSTS IN THE GUARANTEED STUDENT LOAN PROGRAM

The Task Force, recently convened to address the increasing costs of student loan defaults, should make a valuable contribution to addressing the default problem. The resulting report contains proposals which generally provide additional incentives and tools for program participants to use to better manage their programs and control defaults, and should complement legislative and regulatory changes recently implemented.

CHARACTERISTICS OF DEFAULTERS. The Task Force described a typical defaulter as someone who "is not a deadbeat who refuses to pay, but appears to be a dropout who is unable to pay." It also cited examples from several studies of the characteristics of those who default. We are currently developing a profile of guaranteed student loan borrowers and defaulters based on nationwide data that guaranty agencies have submitted to the Department of Education. Although our information is preliminary, it is similar to that reported by the Task Force, while providing a more national perspective. For example, borrowers with higher-than-average risks of default, include those who (1) drop out, (2) attend vocational schools, (3) have lower average income than all borrowers, and (4) have lower than average loan balances.

TASK FORCE PROPOSALS. The Task Force concluded that default costs could be significantly reduced by increasing Pell Grant availability to lower-income students--at an estimated annual federal cost of $3 billion to $7 billion. The Task Force estimates that at least one-third of defaulters are low-income students. Thus, the expected reduction in default costs would be only a portion of the total default costs--perhaps one-third. The savings would be realized over several years as loan activity was decreased and future defaults reduced. Budgetary costs of the proposal would occur much more quickly. Other Task Force proposals are generally responsive to specific problems related to defaulted loans and should have some positive effects. There remain two significant issues not addressed in the report which we believe warrant further congressional consideration.

LENDER RISK SHARING. The Subcommittee may also wish to consider whether lenders should have stronger financial incentives to reduce defaults and improve their collection efforts by sharing a portion of the future default risk. One such mechanism might be similar to those of other federal loan programs in which lenders receive less than full reimbursement when defaults occur. Future GAO work on lender profitability may provide a better sense of the extent to which lenders could assume such risks.

ORIGINATION FEES FOR OTHER LOAN PROGRAMS. Loan origination fees, currently 5 percent, are collected by lenders for regular GSLs to help defray program costs. The Congress should consider charging such a user fee to borrowers obtaining loans under the Parent Loans for Undergraduate Students and Supplemental Loans for Students programs which are also guaranteed against default by the Department of Education.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide GAO's views on the recommendations of the Task Force you recently convened to address the increasing costs of student loan defaults in the Guaranteed Student Loan (GSL) program. I believe that given the likely future increases in default costs, it was an excellent idea to establish such a Task Force, and its report will make a valuable contribution to the efforts to address the default problem. Our recent work in this area corroborates many of the findings of the Task Force and supports the need for many of its proposals. However, there are certain areas that need to be addressed, and I will offer some observations regarding the cost-effectiveness of the most significant proposal, which would greatly expand the use of grants relative to loans.

First, I would like to note that increasing default costs during the last 5 years have already led to a number of recent legislative and regulatory changes intended to reduce defaults. These changes have subjected lenders and guaranty agencies to stronger loan origination and collection standards and increased oversight, which should help reduce defaults and increase collections. Other positive changes include disbursing loans to students in more than one increment, reporting defaulters to credit bureaus, and offsetting debts against defaulters' income tax refund checks. Properly implemented, these changes could significantly reduce the costs of defaults.

Among other things, the Task Force was asked to describe what is known about borrowers who default and to explore how the loan program might be managed to reduce the default rate. I will focus my remarks on the recommendations in the January 26, 1988, Task Force draft report, and on preliminary information we are developing on some characteristics of GSL borrowers and defaulters.

WHAT IS KNOWN ABOUT BORROWERS WHO DEFAULT

As noted by the Task Force, the continuing growth in the GSL program has been accompanied by increasing defaults, although the rate at which borrowers default has not changed greatly. In attempting to describe a typical defaulter, the Task Force contends that generally he or she "is not a deadbeat who refuses to pay, but appears to be a dropout who is unable to pay." The report stated that defaulters tend to have similar characteristics, such as (1) having low-income and minority backgrounds, (2) having small loan balances, (3) not completing much more than the first year of school, and (4) being likely to be unemployed when the loan becomes due.

The Task Force estimates that at least one of every three defaulters are from households with extremely limited financial circumstances, and believes that this proportion has been increasing. As a result, the Task Force states that "it would not be unreasonable to ascribe some portion of the present default costs to the social costs of maintaining the GSL Program."

As the Task Force noted, the reasons for defaults are many and often are tied closely to a borrower's employment status. However, with the recent legislative and regulatory changes, this may be less true for future defaulters. For example, if borrowers are unemployed, lenders are required to grant them deferments for up to a total of 2 years. In addition, lenders can continue to grant forbearance to borrowers who experience temporary financial burdens. If program participants fully use such available measures, many future defaulters should be those who are not eligible for forbearance or deferments and thus are financially able, but not willing, to repay.

Characteristics of Defaulters

Section 1311 of the Higher Education Amendments of 1986 directed GAO to study multistate and single-state guarantors' activities and practices. As part of this study, we are to (1) develop a profile of GSL program borrowers and defaulters and (2) compare default rates and other characteristics of the guaranty agencies. We are in the early stages of preparing these profiles, and while our information is preliminary, the relationships we are observing are similar to some of the Task Force's findings. Our information should therefore be of interest to the Subcommittee because it provides a national perspective, whereas most previous studies have dealt with individual states.

The data were generated from records guaranty agencies prepare and submit to the Department of Education. We used the Department's cumulative, computerized record, as of September 30, 1986, of key statistics for each of 14.3 million GSL borrowers (referred to generally as the "GSL Tape Dump") to construct two data files for our analysis. One file consists of all student borrowers who defaulted (about 1.5 million), and the other was developed from a random sample of 1,000 borrowers from each of the 58 guaranty agencies. Although individual records are often incomplete and unverified, they are the only national data base on the GSL program. We believe this file provides useful information on borrowers' and defaulters' characteristics if used only in calculating aggregate statistics.

Our preliminary analysis shows that, while there may be no "typical defaulter," there are certain demographic characteristics that appear to be more prevalent among defaulters and indicate increased risk of default. We have identified a number of borrower attributes that seem to indicate a higher-than-average risk of default:

-- Students who attend short duration programs or drop out of longer programs are more likely to default. For example, students who attended classes for 1 year or less accounted for 38 percent of the students with loans, but 56 percent of those who defaulted. Students whose records showed they had "withdrawn" before completion were 22 percent of the borrowers, but 37 percent of the defaulters.

-- Independent students (those not dependent on a parent or other person) appear to be a higher risk; they represented 39 percent of the borrowers, but 55 percent of those who defaulted.

-- Students attending vocational schools were 21 percent of the borrowers, but 35 percent of the defaulters.

-- Adjusted gross income appears to be a major indicator of default risk. The average income for all borrowers was about 49 percent higher than that for defaulters.

-- Defaulters appear to have lower loan balances ($2,815) than the average borrower ($3,564).

Although this gives a rough picture at the national level, evidence from individual state agency studies, as well as our preliminary analysis, indicates that defaulter characteristics may vary among the 58 guaranty agencies.

Because one of the questions that we have been asked to address in our ongoing guarantor study is whether out-of-state lenders and agencies are able to adequately service their loan portfolios, we have also begun to look at these geographic relationships. These default comparisons show higher default rates under certain participant relationships, but we cannot draw any policy-related conclusions from this information without further analysis. For example, we found that:

-- Borrowers whose state of residence is different from the state in which the guaranty agency is located appear to be a higher risk, accounting for 15 percent of the loans, but 19 percent of defaults.

-- Borrowers attending schools in the same state as the guaranty agency and receiving loans from lenders in other states were 2.8 percent of the borrowers, but 7.5 percent of the defaulters.

-- Borrowers attending schools and receiving loans from lenders in the same state as the guaranty agency, but who reside in another state, represented 4.8 percent of the borrowers, but 8.8 percent of the defaulters.

HOW TO FURTHER REDUCE THE COSTS OF DEFAULTS

The Task Force identified over 30 proposals that it believed would have a positive effect on the program if implemented. We believe that the Task Force's proposals will generally provide additional incentives or tools for the program participants to use to better manage their programs and control defaults. However, I'd like to comment on the Task Force's proposal to substantially increase Pell Grant funding and on the lack of any significant proposals for (1) having lenders absorb a share of the default risk and (2) charging loan origination fees for other student loan programs such as those for parents.

The Task Force's draft report states that "the only way to accomplish a major reduction in the default rate is to restrict access to high-risk students until they have had a chance to demonstrate their ability to make satisfactory academic progress." It recognized that such a policy would result in a denial of educational opportunity unless other aid programs were expanded. The Task Force concludes that default costs could be significantly reduced by increasing the maximum Pell Grant award for eligible students, thus reducing borrowing.

The Task Force estimates that the federal cost of increasing Pell Grants could be $3 billion to $7 billion a year. The corresponding decrease in default costs would be substantially less because all defaults are estimated to be about $1.6 billion in fiscal year 1988. Furthermore, not all defaulters are low-income students who would be eligible for grants, and many low-income students who would be eligible are now repaying their loans. Income from loan origination fees and default collections would also be lost. As a result, the much smaller default savings would be realized over many years, while the greater budgetary costs for the proposed increase in grants would occur more quickly. If the Task Force estimate that one-third of defaulters are low-income students is correct, it would imply that had the proposal been in effect in the past, the maximum reduction in defaults in fiscal year 1987 would likely have been less than $500 million.

The remaining Task Force proposals are generally responsive to specific problems in how the current program is being administered, and should have some positive effects. They warrant further consideration as the Subcommittee drafts legislation. We were pleased to see that our recent report (Guaranteed Student Loans: Potential Default and Cost Reduction Options, GAO/HRD-88-52BR, Jan. 7, 1988) contributed to the Task Force's discussion and a number of the resulting proposals.

Lender Risk Sharing

One important issue not addressed in the Task Force's report that we believe warrants congressional consideration is the question of whether lenders should have a stronger financial incentive to avoid defaults and improve their collection efforts by sharing some of the default risk. Under current rules, lenders generally continue to receive full interest reimbursement after a default occurs until the claim is paid in full. Thus, lenders have little financial risk in the GSL program unless they fail to fulfill their fiduciary responsibilities as required by law and other program requirements. A risk-sharing mechanism might function in a way similar to provisions of other federal loan programs, in which lenders receive less than full reimbursement when defaults occur.

Alternatively, performance standards might be used in determining the level of risk individual lenders should assume. Standards such as the rate for rejecting default claims and the level of success in getting delinquent borrowers into repayment might be used to increase the risk lenders bear as their performance declined. Such performance standards might also eventually replace more specific requirements for lender collection activities, thus reducing administrative and paperwork requirements in exchange for some risk-sharing.

Section 432(f)(1)(C) of the Higher Education Amendments of 1986 provides for GAO to study the profits lenders are realizing from their participation in the GSL program. The results of this study may give the Subcommittee useful insights into the level of profits lenders earn on their student loans and the extent to which they might absorb some portion of the default-related costs of this program.

Origination Fees for PLUS and SLS Loans

Another option discussed in our January 1988 report that we believe is worth further consideration is charging a loan organization fee to borrowers obtaining loans guaranteed under the Parent Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) programs. Such a fee, currently 5 percent for below market interest rate GSLs, is collected by lenders and remitted to the Department of Education

to help defray program costs. As a result of the needs test mechanism implemented by the 1986 amendments, more student borrowers and their parents--especially those for whom eligibility incomes are above the needs test threshold--will likely be obtaining these market rate loans under PLUS and SLS. In fact, the volume of these loans increased from about $520 million in fiscal year 1986, to $1.1 billion in fiscal year 1987. As more borrowers obtain these market rate loans, associated federal default costs can be expected to increase. Charging an origination fee could help reduce the overall cost of operating these loan programs.

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Mr. Chairman, this concludes my prepared statement. My colleagues and I will be pleased to answer any questions you and the other members of the Subcommittee may have.